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Commodity Smuggling in LDCs: Economic Boon, Political Bane?

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A Research Paper

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A Research Paper

This paper was prepared by Office 25X1
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and may be directed to the Chief, Economics
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Commodity Smuggling in LDCs: Economic Boon, Political Bane? [redacted] 25X1

Summary

Information available as of 1 March 1986 was used in this report.

The massive smuggling of agricultural and mineral commodities out of LDCs poses problems for many LDC governments:

- Smuggling denies LDC treasuries critically needed revenue and foreign exchange. For example, Paraguay's recorded earnings from exports have fallen by two-thirds since 1980, largely due to an increase in smuggling, according to an IMF study.

- The smuggling-related corruption has eroded government power and legitimacy in many LDCs, including Sierra Leone, Paraguay, and the Philippines.

- The flow of contraband across borders has strained relations between many neighboring LDCs. Thailand, Malaysia, and other tin producers often criticize Singapore for accepting large imports of smuggled tin for refining and reexport.

- [redacted] insurgent or opposition groups receiving significant income from commodity smuggling in Burma, Thailand, Zaire, and Mozambique. The National Resistance Army, which recently took power in Uganda, was heavily involved in illegal coffee exports. 25X1

US business interests are often damaged by smuggling. Large informal economies discourage foreign investment by discriminating in favor of locals who can more easily circumvent local laws and operate in the more profitable informal economies. [redacted] 25X1

While smuggling is detrimental to LDC governments, we believe it benefits most developing economies in the short run. Illegal exports fuel large underground economies that provide "second-best" solutions to the problems caused by counterproductive LDC government policies. For example, despite the official 1984 current account deficit, the US Embassy reports that Argentina would actually record a current account surplus if illegal flows were taken into account. As a result, many LDC economies may be substantially healthier than official statistics suggest. Moreover, eroded government authority does not necessarily imply reduced political stability. In many smaller LDCs, the "safety valve" effect of underground economies may be defusing potential civil unrest. At the same time, however, underground trade can slow LDC economic reform by providing a mechanism for the populace to simply circumvent the existing policies.
[redacted] 25X1

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Smuggling has its greatest impact on those smaller countries that are dependent on commodities for a large portion of their export earnings and foreign exchange, such as Bolivia, Senegal, Paraguay, Colombia, Burma, Ghana, Sierra Leone, Guyana, Zaire, and Ethiopia. Larger LDCs also have smuggling problems, however. Embassy studies conclude that illegal commodity exports from Argentina reached several hundred million dollars, and about a billion dollars in Brazil. 25X1

Any hope of reducing commodity smuggling hinges on an unlikely broad restructuring of LDC economic policies. Although liberalization of LDC export regulations would bring much of the smuggled commodities into official channels, a large portion of contraband activity occurs in response to poor policies governing other sectors—such as imports, foreign exchange, and commodity production. Moreover, smuggling tends to become more sophisticated and entrenched as it is allowed to continue and, as extensive as it now is, it has become a fixture in many LDCs' economic and political scenes. 25X1

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25X1

Contents

Declassified in Part - Sanitized Copy Approved for Release 2011/11/18 : CIA-RDP97R00694R000600030001-1

Declassified in Part - Sanitized Copy Approved for Release 2011/11/18 : CIA-RDP97R00694R000600030001-1

Commodity Smuggling in LDCs: Economic Boon, Political Bane?

Scope Note

This research paper is part of the Directorate of Intelligence effort to assess the economic and political dynamics at work in the Third World. This report examines the magnitude of illegal commodity exports from LDCs, and provides a qualitative analysis of the consequences for the affected economies and governments. Because narcotics trafficking has been the subject of a wide array of Directorate research, we focus here on legal agricultural and mineral commodities that are smuggled out to circumvent LDC government regulations. Although smuggling is not a new phenomenon, our concern with its effects is amplified by the LDC debt situation, efforts for fundamental policy reform, and the uncertain stability of many Third World regimes.

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Commodity Smuggling in LDCs: Economic Boon, Political Bane? 25X1

A Pervasive Activity

Much economic activity in the developing countries has been driven underground by the heavily interventionist policies of LDC governments. Although the extent of illegal commerce is inherently difficult to gauge, the effects of such trade permeate economic and political structures throughout the Third World. In particular, the wholesale illegal export of LDC primary commodities has grown to enormous proportions. Smuggled commodity exports fuel LDC parallel markets by providing black-market foreign exchange and by financing banned import goods. 25X1

These agricultural and mineral commodities—both legal and smuggled—play a central role in LDC economies by providing nearly a third of the income of the non-oil-producing LDCs, which in turn sustains a substantial portion of their domestic work forces. Moreover, legal commodity exports often provide LDC governments with the bulk of their treasury revenue and foreign exchange. 25X1

Although commodity smuggling is widespread and affects nearly every LDC, it is most intense where government economic policies are heavyhanded or ill conceived. The impact is greatest among the smaller, poorer LDCs because their generally lower industrial capabilities make them more dependent on primary commodity exports:

- In African countries where economies are based on agricultural exports—particularly ***Ghana, Uganda, Tanzania, Ethiopia,*** and ***Senegal***—20 to 30 percent of the crops are commonly exported illegally for higher prices and harder currency. ***Zaire, Angola, Liberia,*** and ***Sierra Leone*** incur large losses to black markets in minerals, according to trade estimates.

- In South America, over 15 percent of ***Bolivian*** tin is smuggled through Peru; illegal commodity exports from ***Colombia*** were over $200 million last year; gold, diamond, and rice smuggling is propping up the entire economy of ***Guyana***, according to US Embassy reports.

- In Southeast Asia, illegal exports of tin, timber, and gems—important to ***Burma*** and even the larger ***Thai*** and ***Malaysian*** economies—have become major industries and represent significant political forces. 25X1

Estimating Illegal Exports

Ironically, the best way to estimate illegal commodity exports is to examine anomolies in the official commodity trade statistics. There are three types of irregularities that may indicate widespread smuggling:

- Rapid changes in official exports. *When the effective price the Zairian Government set for diamonds fell in January 1984, the value of diamonds bought by the government dropped to just 7 percent of the previous month's levels, according to US Embassy reports.* 25X1

- Implausible export volumes from neighbors. *Although Benin does not grow cocoa, its cocoa exports range from 10,000 to 15,000 metric tons per year—all originally smuggled from Nigeria, traders believe.* 25X1

- Uneven trade figures. *Official statistics show that during 1982-84, South Korea and Japan imported over $240 million more logs from the Philippines than Philippine exporters reported shipped.*

Much of the information on smuggling is more anecdotal, however. For example, there are widespread reports throughout the Third World of trucks, planes, and boats illegally carrying commodities across borders. 25X1

Although its impact is blunted by the size of the overall economies, high-volume commodity smuggling also occurs in larger LDCs:

- In ***Argentina***, illegal exports of grain, soybeans, and beef exceed several hundred million dollars annually, according to Argentine economists.
- In ***Brazil,*** about $1 billion in coffee, soybeans, and gold has been smuggled out in each of the last two years, according to a US Embassy study.
- The ***Philippines*** is rapidly losing its forests—an important export resource—to timber smugglers, many of whom are government officials. [redacted]

Neighboring countries often benefit by receiving and transshipping commodities smuggled out of producing countries. Indeed, entire contraband-based industries have developed in border regions of many adjacent LDCs such as Singapore, Brazil, Benin, Niger, Suriname, and Congo. [redacted]

A Product of Government Policy

Because of their strongly interventionist tendencies and some of the measures imposed on LDC economies as a result of public debt-repayment difficulties, LDC governments often employ policies that tamper with the trade sector by taxing exports, controlling foreign exchange, and restricting imports. Such policies create powerful incentives for private commodity producers to circumvent legal trade channels. [redacted]

Avoiding State Revenue Collection

A primary reason for commodity smuggling is *tax avoidance.* LDC treasuries often lack efficient mechanisms for obtaining revenue through income taxes or domestic sales taxes, and, because commodities are often the largest, best-established of LDCs' export industries, governments frequently tax commodity exports for a substantial portion of state revenues. This creates incentives for exporters to smuggle rather than pay taxes. For example, Argentina's massive illegal exports are largely the result of a substantial tax—about 25 percent, depending on the commodity—on agricultural exports. [redacted]

Commodities are often smuggled *to get a higher price by avoiding government-mandated sales to producer marketing boards* (PMBs). These parastatals generate income by buying from producers at below-market prices and then selling the goods on the world market at the prevailing world price. The revenue collected under this scheme is sometimes returned to subsidize inputs to domestic producers, but is commonly used to boost government revenues. The greater the difference between the PMB price and the world price—or the PMB price in the neighboring country—the greater the smuggler's profit. For example, in 1984 there 25X1 was what the African press called "a massive and spontaneous rejection of the state marketing system" by Senegalese groundnut farmers. The PMB price for groundnuts—which normally account for a fourth of Senegal's exports—fell to 65 percent of the free market price. Consequently, half the crop was withheld, sold on the black market, or trucked across the 25X1 border. [redacted]

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Bypassing Currency Laws

Commodities are also smuggled to *evade requirements in many LDCs to convert the earned revenue into domestic currency.* By requiring exporters to surrender a large portion of their foreign currency earnings to the central bank in exchange for domestic currency, LDC governments acquire the hard monetary reserves to finance approved imports and service foreign public debt. Private exporters who are left with less valuable domestic currency often do not 25X1 report commodity sales and, therefore, keep the foreign currency. In turn, they use this harder, international currency to import goods that are banned by the government, or shelter it in foreign assets as a means of capital flight. [redacted] 25X1

Illegal exports often are a means of *avoiding overvalued LDC currencies.* Although the price paid to a producer might equal the world price at the LDC government's official exchange rate, the true, black-market value of the domestic currency is often much lower. As a result, a smuggler who can sell the commodity at the black-market exchange rate can

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The Nature of the Business: Sophisticated

Commodity smuggling is not a peasant farmer carrying a bag of coffee across an unguarded border. Smuggling in LDCs is usually a sophisticated, well-organized industry run by professionals. Miners and farmers sell their commodities to middlemen who are often employed by larger contraband organizations. These organizations are often run by wealthy businessmen, or even government officials, and are well situated to arrange illegal shipments, bribe customs officials, and handle complex financing schemes for the goods sold. [redacted]

There are three basic means of smuggling:

- Underinvoicing. *By misreporting the amount shipped through normal channels, exporters can smuggle using the relatively efficient, legitimate transportation infrastructure. This method plagues Argentine grain exports, for example.*

- Bribery. *Another way to use the official export channels is to simply bribe officials to let goods through without levying duties or penalties. This means is used to varying degrees in nearly every LDC.*

- Stealth. *Avoiding border guards, customs agents, and antismuggling squads is easy in LDCs that have long, rugged borders or coastlines.*

Getting a commodity to the world market may require using all three methods. For example, some Thai tin miners operate illegally at night, and underreport the quantity of tin mined. The tin is then 25X1 *shipped clandestinely to "friendly" refiners, often in Singapore. The US Embassy reports that Thai smuggling boats are faster and have more modern radar equipment than the government customs boats. If caught by a patrol boat, moreover, the captain will very likely accept a bribe.* [redacted] 25X1

The sophistication of smuggling can be seen in their financing operations. Trade journals report that payment to Brazilian coffee smugglers is made in US dollars to Swiss bank accounts. Even small operations have some structure: cocoa-producing families in Ghana pool their funds to hire smugglers to take their crops into neighboring countries, [redacted] 25X1
[redacted] 25X1

profit by the amount the currency is overvalued. For example, the US Embassy in Rangoon reported last year that the official Burmese exchange rate was 8.6 kyat to the dollar, while on the black market it took 27 kyat to buy a dollar. Tungsten, rubber, jade, and rice producers could therefore obtain over three times as many kyats per pound for their goods on the black market than they could by selling to the government at the official exchange rate. [redacted]

Circumventing Export Prohibitions

A final reason for smuggling is to allow LDC producers *to get around export quotas and bans.* Prior to the collapse of the International Tin Agreement, Southeast Asian tin producers were held to export quotas by international treaty in an effort to support prices. As a result, more than 10 percent of tin consumed worldwide in 1984 was originally smuggled out of tin-producing countries, according to trade estimates. LDC governments often limit food-crop exports to sustain adequate domestic supplies. Such restrictions, coupled with higher food prices in neighboring countries, have led to widespread foodstuff smuggling throughout Africa and parts of Southeast Asia. [redacted] 25X1

Reactions to Policy Changes 25X1

Although commodity smuggling is often cited as a "chronic" problem, there is evidence that LDC policy reforms can quickly raise the amount of a commodity exported through official channels. For example, when Argentina introduced a dual exchange rate in

1982, trade statistics show that the flow of grain through official channels fell to half the normal level—much of the difference was smuggled overland to Paraguay or shipped without being declared. Largely as a result of the lost revenue and foreign exchange, Argentina reversed its exchange rate policy, and the level of official grain exports rose. In another dramatic example, much of Paraguay's 600,000 metric tons of soybeans were smuggled out during the 1982 season and sold for higher prices in Brazil. In 1983, however, the soybean price was set higher in Paraguay—causing the flow to reverse with perhaps 400,000 metric tons being smuggled from Brazil.

That Boosts the Private Sector

Just as legal exports finance imports in legal economies, commodity export smuggling fuels underground trade in many LDCs. This underground trade, in turn, often boosts an LDC's overall domestic economy. As a result, smuggling provides a "second-best" solution to the problems caused by counterproductive government polices. Smuggling does this by contributing to the economy both quantitatively and qualitatively:

- *Quantitatively,* smuggling provides a market for commodity producers who would not make as much profit within legal marketing channels. This black market provides incentives for increased production and, as a result, official statistics may reflect only part of the actual commodity production—and therefore income—in an LDC. For example, increased smuggling is largely responsible for reports of declining tin production in Thailand, diamond production in Sierra Leone, cotton exports from Paraguay, and groundnut harvests in Senegal. This "shadow" production increases employment in LDCs beyond the level that would exist in the absence of the underground economy. The income generated from this added employment helps buoy the economy countrywide.

- *Qualitatively,* black-market foreign exchange received by commodity smugglers is frequently used to import needed capital equipment, production inputs, and consumer goods. Such purchases can compensate for poor governmental economic planning by providing the economy with a more efficient "mix" of import goods. According to Embassy reporting, illegal gold and diamond exports have become "major engines" to the parallel economy of Guyana. Shops along the border in Brazil buy smuggled Guyanese commodities and sell consumer goods to be smuggled back to Guyana's black market. 25X1

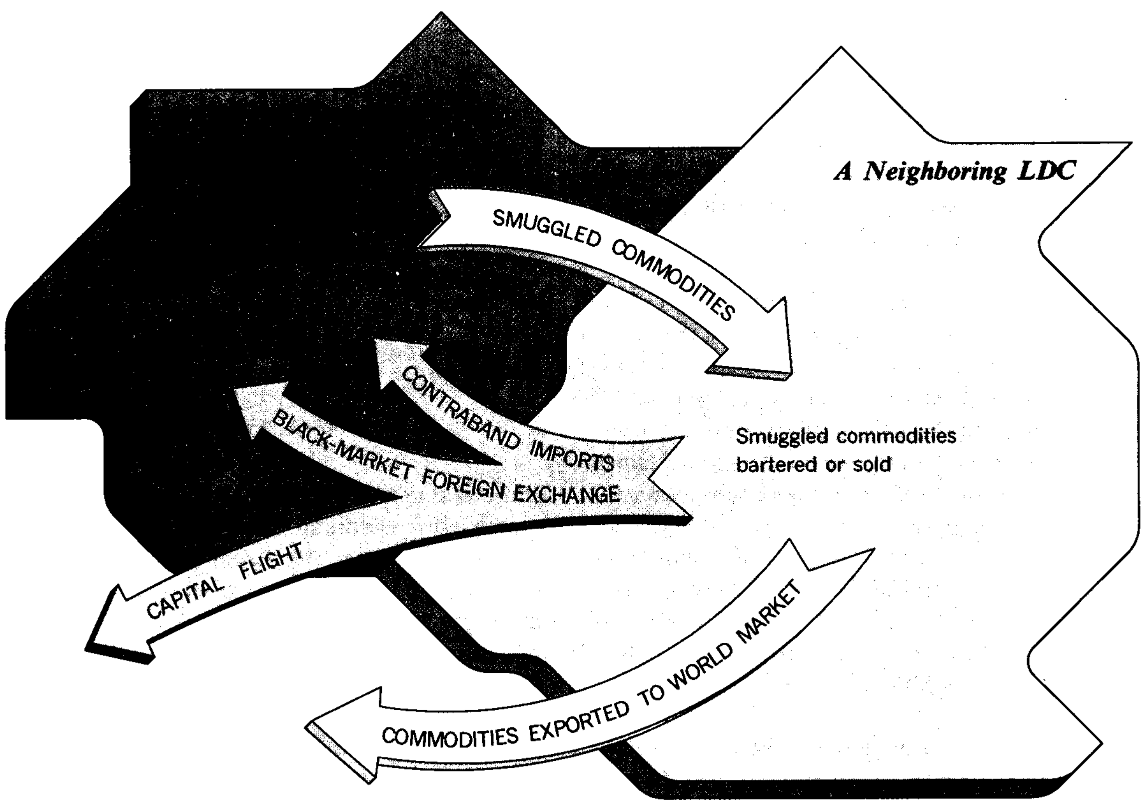
Because this two-way illegal trade helps keep some economies afloat, authorities often "look the other way" by allowing contraband consumer imports to reach foodshop shelves. 25X1 For example, to keep shops filled with consumer goods, Sierra Leone allows some businesses to circumvent foreign exchange rules designed to discourage diamond, coffee, and cocoa smuggling, according to local press reports. Although the smaller LDCs depend more on black markets, Embassy reporting indicates even the large Argentine economy is boosted by a substantial amount of illegal trade. Indeed, despite an official 1984 current account deficit, the US Embassy reports that Argentina would actually record a current account surplus if illegal flows were taken into account. This implies many LDC economies may be healthier than official statistics would suggest—particularly those published by the LDC governments. 25X1

> *Most of Guyana's gold production is thought to be smuggled out . . . this gold when sold abroad becomes one of the prime sources of foreign exchange for the parallel economy in Guyana . . . [and is] a major reason why predictions of the imminent collapse of the Guyanese economy have repeatedly been wrong.* 25X1
>
> *Excerpt from March 1985*
> *US Embassy cable* 25X1

When commodity smuggling is used as a means of capital flight, however, it may contribute to the resource drain from underdeveloped economies. In nearly every case we examined there was evidence that some of the illegal proceeds remained abroad.

The Underground Balance of Trade

Illegal commodity exporting is only one side of the underground balance of trade. After a commodity is smuggled abroad, it is bartered for goods to be smuggled back, or is sold for cash. If a hard currency, such as the dollar, is received, the money is often brought back to the original country for the black foreign exchange market. If the commodity was smuggled as a means of capital flight, the hard currency may be deposited in foreign banks or invested abroad. The commodities originally smuggled are commonly sold on the world market as legitimate goods.



[redacted] 25X1

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For example, the US Embassy in Bangkok reports that black-market revenues have spurred investment by tin-smuggling "godfathers" in a variety of overseas projects. Nonetheless, with the exception of diamond smuggling from West Africa, we believe that the added income from contraband exports exceeds the capital outflow. [redacted] 25X1

Erodes Government Authority

Although widespread illegal economic activity is evidence of an already weak government authority, commodity smuggling can further undercut LDC governments' ability to carry out their policy agendas by sapping public resources, by corrupting public officials and institutions, and by fueling the parallel economies that provide the populace with an alternative to working "within the system." 25X1

Denying the Government Wealth

Commodity smuggling erodes government authority by denying the government wealth:

- The *loss of export taxes* to smuggling is a severe cost to many commodity-dependent LDCs. The Ethiopian Government, for example, gets an average of 10 percent of its revenue from coffee exports. But a government source reports that much—perhaps most—of the country's coffee never reaches the state's coffee-buying agency. Paraguay's revenue from exports has fallen by two-thirds over the last five years, largely due to an increase in smuggling, according to an IMF study.

- Perhaps more critical for LDC governments is the *loss of foreign exchange*. Unlike revenue that can be acquired domestically, foreign exchange can normally be obtained only through exports in return for hard currency. In the Ethiopian case given above, the government earns most of its foreign exchange from coffee. Many other governments in recent years have lost significant amounts of foreign exchange to unofficial commodity exports. These include the Governments of Sierra Leone, Uganda, Angola, Nigeria, Senegal, Ghana, the Central African Republic, Zaire, Guyana, Paraguay, Bolivia, Thailand, and the Philippines.

In addition to reducing government revenues, smuggling often leads LDC governments to spend large sums on antismuggling enforcement measures. In Southeast Asia, the Thai Government has a Center to Suppress Tin Smuggling, and the Philippines has tried to use its Army to stop timber smuggling.

Corrupting Political Systems

There is widespread involvement of LDC officials in corrupt activity related to smuggling. At the lower levels, border guards routinely "tax" contraband

"They want to broaden the National Agreement to include radicals and liberals . . ."

"To make it truly national they shouldn't forget the smugglers or the drug traffickers."

From a Paraguayan newspaper

trade as it passes, rather than halt the flow. Embassies report many examples: local customs officials in Burma do little to stop the illegal export of rubber, tungsten, and shrimp but are rumored to take enough bribes to retire after two years; Zairian customs inspectors have open drawers of cash for routine deposits by diamond smugglers; different Ghanaian agencies duplicate efforts and work long hours patrolling the border, taking payoffs and contraband goods for themselves. 25X1

At higher government levels the corruption is equally widespread, but is more systematic. Rather than allowing illegal exports in exchange for occasional bribes, top authorities often have continuing—almost contractual—relationships with those who run large smuggling enterprises. 25X1

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Family connections within governments often allow individuals to conduct smuggling operations free from prosecution. The US Embassy in Paraguay reports that a businessman charged with cotton smuggling fled to the home of the President's daughter until the charges were dropped. [redacted]

Beyond corrupting individuals, entire commodity-policy institutions and enforcement efforts can be shaped by illegal trading in LDCs. [redacted]

Other Impacts
LDC commodity smuggling has a number of other effects that frustrate government authority. In addition to simply reducing government revenue and foreign exchange, a large underground economy undercuts the central government's efforts to control the overall economy. Import-substitution policies depend on controlling both the flow of trade and the allocation of foreign exchange. But in many countries a substantial percentage of trade is unregistered and therefore stymies government efforts to control industrial development. Moreover, goods brought into a region in exchange for illegal export commodities are often banned consumer goods. For example, the Guyanese Government is unable to finance what it considers sorely needed production inputs because much of the economy's foreign currency is obtained from illegal exports of rice, gold, diamonds, shrimp, and sugar, and is not available to government planners, according to a US Embassy study. Yet many of these production inputs can be bought on the black market in Guyana—smuggled in and financed by smuggled commodity exports. Another example of the government's reduced role in the economy is the limited benefit a currency devaluation has when a large portion of the trade is illegal and does not involve the official currency. [redacted] 25X1

The widespread smuggling of export commodities can force otherwise legitimate producers to engage in 25X1
black-market trade. Because illegal exporters get higher returns on their output and ignore costly government regulations, they present stiff competition to businesses that stay within the law. This forces 25X1
some producers to either join the smugglers or quit altogether. For example, the US Embassy in Bangkok reports that illegal tin and tungsten operations in southern Thailand—an area the Embassy calls a "free trade zone" for smuggling—has caused legitimate US mines to fold. DeBeers ceased its buying operations in 1983 in Sierra Leone because of the company's inability to compete with buyers who bought diamonds at the black-market exchange rate, according to Embassy reporting. [redacted] 25X1

Finally, commodity smuggling can inhibit government authority by providing insurgent groups with income. Some groups curry favor with the rural populace by conducting the illegal trade that raises farmer incomes. Smuggling is a natural business for insurgent groups because commodity production usually occurs in rugged areas close to borders and mandates no contact with authorities. [redacted] 25X1

Several insurgent groups in Burma and Thailand also are involved in smuggling a variety of important export commodities, such as jade, teak, and fish, as a means of financing their insurgencies. In addition to smuggling commodities, these insurgents mine jade, provide protection for existing smuggling operations, or even tax and pirate freelance smugglers. [redacted] 25X1
[redacted] insurgents or opposition groups receiving substantial income from commodity smuggling in Zaire and Mozambique. Some groups may be more concerned with profit margins, however, than with their stated political goals. [redacted] 25X1

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Reaching the World Market

Commodities smuggled out of one LDC are commonly sold in a neighboring country that has less costly regulations and then reexported through normal channels as products of the second country. The governments of these intermediate countries benefit from the effective "increase" in their taxable exports. World cocoa traders report that they are willing to pay a small premium for beans from Ivory Coast, knowing the shipments will contain some higher-quality beans smuggled from Ghana. The Ivorian Government benefits by taxing—at about 50 percent—a higher export volume at this premium price. According to US Embassy reporting, Peru's only tin mine produced 1,200 metric tons in 1983. Yet in 1984 Peru claimed it exported 4,500 metric tons. The difference is the roughly 15 percent of the Bolivian tin smuggled.

And Strains International Relations

In addition to creating domestic political difficulties, smuggling has led to diplomatic strains between neighboring LDCs. A commodity exporter who is losing precious foreign exchange to a neighboring LDC often suspects the neighboring government of complicity. Indeed, because of the benefits of receiving and reexporting smuggled commodities, coupled with the financial and political costs of contraband crackdowns, neighboring governments often abet illegal traders. For example, Paraguay encourages the smuggling of coffee and soybeans from Brazil by setting more favorable exchange rates for these products destined for reexport, according to Embassy reporting. Most other cases of aid and comfort given to smugglers is more subtle, however. For example, northern Brazil has many stores specializing in buying smuggled gold and diamonds from Guyana and in selling consumer items that will be illegally taken back to Guyana.

As a result, reactions by LDC governments suffering such commodity losses range from propaganda against their neighbors to border closures. Government efforts to control smuggling in West Africa have hampered the flow of regular commerce between countries and often lead to political disputes:

- Nigeria's border closures to prevent commodity and currency smuggling temporarily interfered with the flow of food aid to Chad, according to the US Embassy in Lagos.
- The US Embassy in Accra reports antismuggling policies there have reduced regular trade between Ghana and Togo, Ivory Coast, and the landlocked Burkina.
- Singapore is often criticized by Thailand, Malaysia, and other tin-exporting countries for accepting massive imports of smuggled tin and refining it for reexport.

The perceived unwillingness of a neighboring government to help stop commodity smuggling has also strained relations between Guyana and Suriname, Uganda and Kenya, Burma and Thailand, and others.

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The Political Bottom Line

In the short run, the political fallout from widespread commodity smuggling is complex and depends heavily on the local situation. The erosion of governmental authority resulting from widespread illegal exports may pose challenges to regimes facing acute political or economic problems:

- The prospects for survival of governments opposed by insurgencies—such as those in the Philippines or Burma—may be reduced by the combination of lost treasury revenue, corruption within the government ranks, and the support contraband trade provides the insurgents.

- In many more cases, the loss of government revenue comes at a time when hard currency foreign exchange is critical for public debt repayment. Argentina, Sierra Leone, Paraguay, and Ecuador fall into this category. 25X1

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On the other hand, although the underground economy weakens government authority, it may actually boost political stability in the short run as black-market activity defuses civil unrest over economic matters. In addition to employing a potentially disgruntled labor force, evasion of government policies reduces the negative impact of those policies—reducing the popular desire for a change in government. This is particularly true in agriculture, where the illegal proceeds can raise the incomes of rural areas. At more influential levels, many powerful contrabandists operate profitably under the protection of corrupt officials. This gives both parties a vested interest in maintaining the status quo.

> *By tolerating smuggling, President Stroessner placates the powerful and unscrupulous, who, while getting rich circumventing the rules, are then less likely to challenge the rulemaker himself. At the same time, thanks to smuggling, the economy muddles through.*
>
> *Excerpt from March 1985*
> *US Embassy cable from Paraguay*

In the long run, despite added prosperity from commodity smuggling, the fallout from large underground economies probably adversely affects the political and economic health of the affected LDCs. For example, large informal economies may discourage direct foreign investment by "discriminating" in favor of locals who can more easily circumvent whatever rules exist. This is clearly seen in the cases of DeBeers pulling out of Sierra Leone, US mining companies being forced out of Thailand, and Korean timber companies being targeted by Philippine antismuggling investigators.

Moreover, even the greater political stability that smuggling provides as a benefit may, by slowing LDC economic policy reform, be a detriment in the longer run. Popular pressure is less likely to build for reform where policies are being ignored by the private sector or exploited by officials for personal gain. This greater political rigidity could be hindering efforts by the IMF, the World Bank, and the United States under the Baker Initiative to encourage the formal liberalization of LDC economies. Overall, we see smuggling as probably helping LDCs in the short run, but, in many ways, preventing the steps necessary to substantially improve their economies.

Any hope of reducing commodity smuggling in LDCs hinges on the restructuring of LDC economic policies. Crackdowns on commodity smuggling by LDC governments are nearly always selective, ineffective, and temporary, and therefore do not stem the flow. Although liberalization of LDC export regimes would bring much of the smuggled commodities into official channels, a large portion of contraband exporting occurs as a response to poor policies governing other sectors—such as imports, foreign exchange, and commodity production. Moreover, as smuggling continues to flourish, the infrastructure of underground economies becomes more entrenched, and circumventing government laws becomes easier.

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Although LDCs are unlikely to enact the sweeping changes necessary, progress might be made on some fronts. The wave of LDC commodity export-promotion policies that followed the debt crisis carried with it greater incentives for commodity producers. Often at the urging of the IMF or the World Bank, many LDCs devalued their currencies, raised producer prices, and took steps to reduce the governmental role in commodity export. A continuation of this trend—or at least a slowing of any movement toward greater governmental intervention—would inhibit the growth of illegal trade. In their efforts to climb away from their debt problems, however, LDCs have increased their restrictions on capital and foreign exchange outflows and curtailed legal imports. These restrictions on free trade have encouraged export smuggling.

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Given the vested interests involved, the larger, wealthier, more stable LDCs trying to cope with commodity smuggling—Brazil, Argentina, and Thailand, for example—stand a better chance of eventually striking a sustainable balance between controlling trade and profiting from the export of their natural resources. The wide array of lower-income, struggling LDCs that face the smuggling dilemma are more constrained by their dependence on commodity exports and are apt to hesitate taking what may be risky steps toward liberalization. Moreover, these poorer LDCs generally are more hamstrung by the corruption and political forces that operate alongside contraband trade. As a result, widespread commodity smuggling has become a fixture in many LDCs' political and economic scenes.

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Appendix

A Look at Commodity Export Smuggling

Country	Extent	Causes	Government Actions and Attitudes	Economic Effects	Comments
Paraguay	Substantial amounts of **cotton**, the number-one export, are smuggled to manufacturers in Brazil.	Price of cotton in Brazil is often double the official Paraguayan price. Smuggled cotton earns US dollars or Brazilian cruzaros, rather than the overvalued Paraguayan guaranies.	A recent enforcement crackdown concentrated on smaller operators. [redacted]	Loss of large amounts of foreign exchange. Embassy reports, however, that import and export smuggling are helping the economy withstand poor government policies.	Paraguay encourages the smuggling of coffee and soybeans from Brazil by setting more favorable exchange rates for these products destined for reexport.
Brazil	The government estimates that 800,000 bags of **coffee** were smuggled to Paraguay last season.	Farmers are paid low producer prices by the Brazilian state trading organizations. Coffee prices are reportedly five times higher in Paraguay.	In 1984, the government raised coffee prices to farmers by 10 percent, and the Minister of Justice last year announced a crackdown on borders.	Smuggling has reduced Brazil's export revenue but has supported farm incomes.	Press reports claim coffee smuggling is closely linked to drug smuggling.
	We estimate more than 100,000 metric tons of **soybeans** were smuggled to Paraguay last season.	To keep domestic prices down and encourage value-added exports, the government restricts soybean exports.	Recent reduction of existing export quotas is likely to increase smuggling this season.	Weakens Brazil's efforts to export processed soy products.	In 1983, 400,000 metric tons of soybeans were smuggled into Paraguay.
	20 to 25 percent of Brazil's **gold** output is smuggled, say government officials.	Private prospectors must sell to the government at below world prices.	Private mining is overseen by 10 government agencies led by the Secret Service.	Loss of potential Central Bank gold reserves and foreign exchange.	Brazil is amidst a gold rush, with 300,000 Brazilians mining the Amazon, and has become the world's fourth-largest producer.
Bolivia	15 percent of **tin** exports are illegally shipped to Peru.	Government pays producers in overvalued pesos.	[redacted]	Tin is the mainstay of Bolivian exports. Smuggling is sapping foreign exchange receipts.	Peru's tin exports are nearly four times higher than its production capacity.
	50 to 75 percent of **gold** output is smuggled to Argentina and the United States.	Last year, the government failed even to pay pesos and began issuing vouchers.	The penalty for illegal gold mining is confiscation.	Increased gold production is a top priority of the Mining Ministry. Smuggling is undermining government efforts to reap the benefits of gold production.	Significant portions of Bolivia's **cattle**, **sugar**, **coffee**, and **timber** resources are also smuggled out.
Venezuela	16 percent of 1984's **cocoa** production was smuggled to Colombia and Trinidad, according to trade reports.	The government's cocoa purchasing monopoly pays 40 percent less than Colombia's.	Producer prices were raised in August 1984 but are still too low.	Venezuela is trying to boost nonoil commodity exports but says all of last year's production increase circumvented government channels.	The government estimates that two-thirds of Venezuelan **gold** production is smuggled by a complex network of gold, **diamond**, and drug smugglers.

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A Look at Commodity Export Smuggling (continued)

Country	Extent	Causes	Government Actions and Attitudes	Economic Effects	Comments
Argentina	The Embassy reports black-market agricultural exports exceeded several hundred million US dollars last year. This was largely **grain**, **soybeans**, and **beef**.	Taxes and exchange rate restrictions lower the value received by 25 percent. Moreover, the smuggled exports fetch dollars, which can be held overseas.	The government occasionally adjusts export policies in an effort to raise foreign exchange.	Argentina depends on agriculture for 70 percent of its export earnings. Smuggled goods boost farm income but deny the Central Bank needed foreign exchange.	In addition to physical smuggling into Paraguay and Brazil, much of the shipment through normal channels is underinvoiced.
Ghana	About 20 percent of the **cocoa** crop is smuggled to neighboring Ivory Coast and Benin. **Coffee**, **gold**, and **diamonds** are also said to be smuggled.	Low producer prices; lack of goods for farmers to buy in Ghana; harder currency obtainable over the border.	Has worked to raise prices and consumer goods availability, while taking stern measures against smugglers. Occasionally closes its borders.	In addition to reducing foreign exchange and revenue, smuggling has caused strains in Ghana's relations with its neighbors.	Artificial colonial borders have split families and tribes, so cocoa farmers pay little attention to government boundaries.
Nigeria	Ten percent of **cocoa** crop—Nigeria's second-largest earner—is taken illegally to Benin.	Producer prices are 40 percent of world price.		Cocoa smuggling is undermining government efforts to compensate for sagging oil revenues by rehabilitating the cocoa industry.	Smuggling of all kinds has damaged trade and political relations with neighbors.
Senegal	About half of the 1985 **groundnut** crop—Senegal's main export—bypassed government channels.	World groundnut prices rose in 1984, but official Senegal prices remained low—roughly 65 percent of the black-market price.	The government is largely dismantling the state marketing monopoly. 25X6	This year's buying shortfall has dealt a severe blow to government earnings, according to US Embassy reports.	Those groundnuts not sold to the government are either smuggled out, sold on the domestic black market, or held by the farmer for crushing into oil.
Philippines	Illegal **log** exports to Japan and South Korea over $240 million from 1982-84, according to the US Embassy.	Smugglers ignore export and environmental rules.	In 1985 there were selective crackdowns	Rapid depletion of important forest resources.	
Thailand	Prior to **tin** crisis, as much as 20 percent of tin exports were illegal.	Export taxes, royalties, and quotas. 25X6	Government maintains an organized antismuggling operation.	Loss of revenue and foreign exchange for government; boosts local economy in south.	
Burma	Large amounts of Burma's major exports—**teak**, **gems**, and **ores**—are smuggled out.	Low government prices encourage illegal exports; insurgents run illegal mines.	Army is fighting smuggling largely to disrupt insurgents' income.	Transfers commodity income from government to farmers, miners, and insurgents.	Shan and other insurgent groups rely heavily on drug and commodity smuggling for revenue.

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